



REPORT OF EXAMINATION

PEMCO INSURANCE
COMPANY

As of December 31, 1997 and 1998

CHIEF EXAMINER'S AFFIDAVIT

I hereby certify I have read the attached Report of the Financial Examination of the PEMCO INSURANCE COMPANY of Seattle, Washington. This report shows the financial condition and related corporate matters as of December 31, 1998.

Patrick H. McNaughton, Chief Examiner

PEMCO INSURANCE COMPANY
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Seattle, Washington
January 2, 2004

The Honorable Alfred W. Gross
Commissioner, Commonwealth of Virginia
Bureau of Insurance
Chair, NAIC Financial Condition Committee
PO Box 1157
Richmond, VA 23218

The Honorable Merwin Stewart
Commissioner, Utah Department of Insurance
NAIC Secretary, Western Zone
3110 State Office Building
Salt Lake City, UT 84114-1201

The Honorable Mike Kreidler
Insurance Commissioner, State of Washington
PO Box 40255
Olympia, WA 98504-0255

Dear Commissioners:

In accordance with your instructions and in compliance with the statutes of the state of Washington, Chapter 48.03 Revised Code of Washington, an Examination has been made of the corporate affairs and financial records of the

PEMCO INSURANCE COMPANY
of
Seattle, Washington

hereinafter referred to as the Company, at its home office located at 325 Eastlake Avenue East, Seattle, Washington 98109-5466. The following report on the examination is respectfully submitted showing the condition of the Company as of December 31, 1997 and 1998.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 1992. The current examination conducted by insurance examiners from the state of Washington and covered the period from January 1, 1993 through December 31, 1998. The examination was conducted in accordance with the laws and regulations of the state of Washington contained in Title 48 of the Revised Code of Washington (RCW), Title 284 of the Washington Administrative Code (WAC), and the examination procedures recommended by the National Association of Insurance Commissioners found in the NAIC Financial Condition Examiner's Handbook.

Corporate records and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. The Company's certified public accountant's work papers were reviewed and utilized where possible to support efficiency in the examination.

INSTRUCTIONS

Pursuant to the findings and conclusions of the examiners and actuary, in accordance with sound actuarial principals, Title 48 RCW, Title 284 WAC and the NAIC Accounting Practices and Procedures Manual (APPM) for property and casualty insurance companies, the Company is hereby instructed to comply with the following:

1. **THE COMPANY IS INSTRUCTED** to comply with **WAC 284-02-080** and file all amendments to its bylaws with the insurance commissioner. Reference "CORPORATE RECORDS" (page 6).
2. **THE COMPANY IS INSTRUCTED** to comply with **WAC 284-07-050(2)** which requires adherence to the appropriate Annual Statement Instructions and the Accounting Practices and Procedures Manuals promulgated by the NAIC for the completion of the annual statement. **RCW 48.05.250** requires the Company to file with the insurance commissioner a true annual statement of its financial condition, transactions, and affairs. Reference "CORPORATE RECORDS" (page 6).
3. **THE COMPANY IS INSTRUCTED** to comply with **RCW 48.07.040**. This section of the Washington Insurance Code covers compliance with the actions required in the articles of incorporation and bylaws with regards to election of officers. Reference "OFFICERS" (page 5).

HISTORY

PEMCO Insurance Company (PIC) was incorporated on May 4, 1972, as a stock multiple line property and casualty insurance company under the laws of the state of Washington. PIC is licensed to operate only in the state of Washington. The Company's Certificate of Authority was issued on August 22, 1972 and authorized the business of property, vehicle, casualty and surety insurance.

CAPITALIZATION:

The authorized capital of the corporation began with 200,000 shares of \$10 par value common capital stock. Pursuant to Chapter 48.06 RCW, the Company obtained a solicitation permit on May 1, 1972 to sell 100,000 shares. In accordance with the Application for Solicitation Permit, 100,000 shares were issued to Public Employees Mutual Casualty Company, a Washington mutual multiple line insurer. An additional \$10 per share was collected as contributed surplus. Total consideration was received in the amount of \$2,000,000 and was divided, \$1,000,000 in paid up capital and \$1,000,000 as contributed surplus.

During 1977, pursuant to RCW 48.31.010, the merger of Public Employees Mutual Casualty Company into Public Employees Mutual Insurance Company was approved, giving it 100% ownership of PEMCO Insurance Company. The name was later changed to PEMCO Mutual Insurance Company in January 1989. PMIC has been the only shareholder since 1977, and no changes have been made to the authorized or outstanding capital since incorporation.

STOCKHOLDERS DIVIDEND DISTRIBUTIONS:

There have been no stockholders' dividends declared or paid during the six year examination period, January 1, 1993 through December 31, 1998.

AFFILIATED INSURANCE COMPANIES

PEMCO Mutual Insurance Company (PMIC) is organized as a mutual insurer in the state of Washington. The Company is licensed to operate only in the state of Washington and writes multiple-lines property and casualty coverage for the general public.

PEMCO Corporation (CORP) is a stock company that was incorporated in the state of Washington during April 1963.

CORP currently provides data processing services, and leases automobiles and office equipment to the three insurance companies, the Public Employees Insurance Agency and the other companies under common management. The services are purchased per agreement.

PEMCO Life Insurance Company (PLIC) is a Washington corporation organized as a stock insurance company on May 27, 1963. The Company's Certificate of Authority was issued on June 11, 1963 and authorized the business of life and disability insurance. The Company is also authorized to write participating or non-participating insurance coverages. The Company is a wholly owned subsidiary of PEMCO Corporation.

NON-INSURANCE COMPANIES UNDER COMMON MANAGEMENT

Public Employees Insurance Agency (The Agency) is a stock company incorporated in the state of Washington during October 1968. The Agency sells insurance and collects premium on behalf of the affiliated insurance companies.

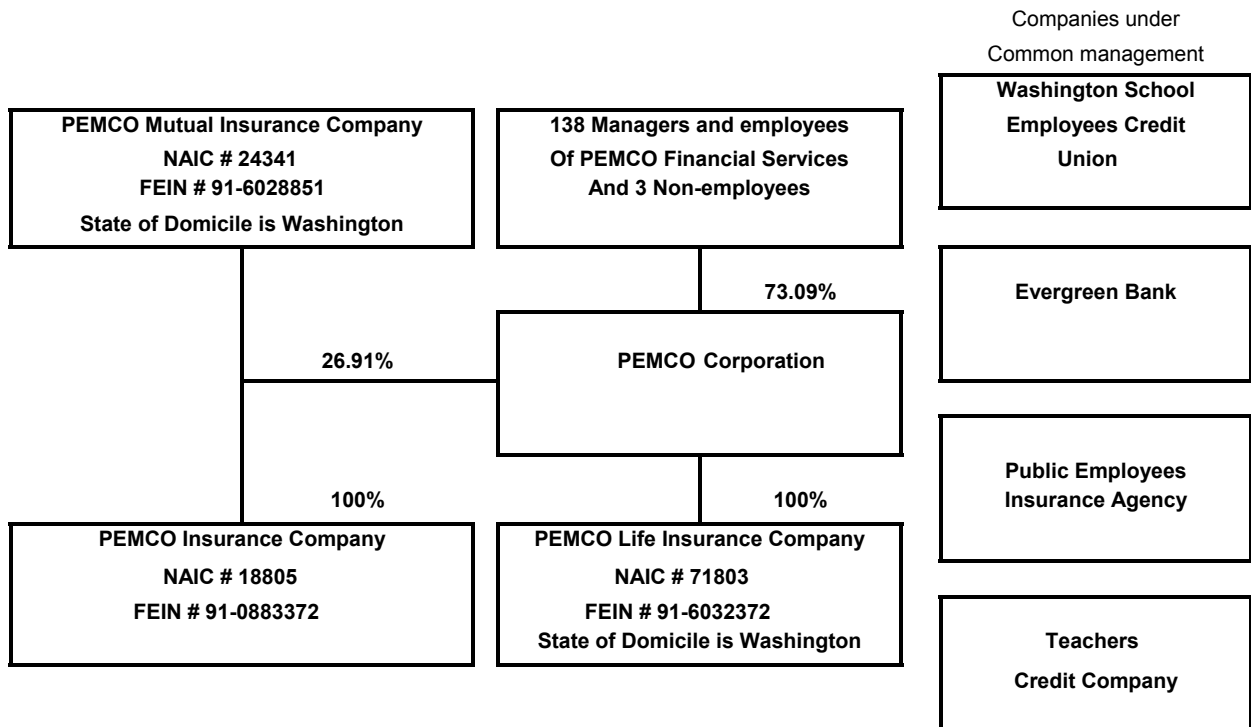
Washington School Employees Credit Union (WSECU) was founded by Robert J. Handy and a group of educators in 1936. Today, the Credit Union is one of the largest members owned credit unions in the state with more than 63,000 members, serving school employees and their relatives who live in Washington.

Evergreen Bank (EB), formerly Teachers State Bank, was incorporated under the laws of the state of Washington on December 28, 1970 and commenced business on October 1, 1971. EB provides banking services for all affiliated companies more than 8,200 other businesses and individual customers. EB has offices in Lynnwood and Seattle and they provide a wide range of products and services, including deposit accounts, loans, and investments.

Teachers Credit Company (TCC) was incorporated under the laws of the state of Washington during 1941. TCC retains and exercises the proxy votes of the policy holder members of the mutual company, PMIC.

ORGANIZATIONAL CHART

The following organizational chart displays the relationship of all of the affiliates under the PEMCO holding company system and other non-insurance companies under common management.



Note: The affiliated companies under the holding company system do not have any ownership interest in the companies listed under common management, other than PMIC owning 22,000 shares (3.3%) and PIC owning 10,000 shares (1.5%) of Evergreen Bank common stock.

MANAGEMENT and CONTROL

BOARD OF DIRECTORS:

Control of the Company is vested in the Board of Directors (BOD) consisting of nine (9) members as of December 31, 1998. All board members are elected for a one year term at the annual stockholders meeting held on the third Friday in April of each year pursuant to Article III of the Corporate Bylaws.

<u>Name and Address</u>	<u>Principal Business Affiliation</u>	<u>Member Since</u>
Stan William McNaughton	President and Chief Operating Officer BOD, PMIC, PIC and PLIC	1998
Richard Stanley White	Secretary BOD, PMIC and PIC	1972
Ed Kenneth Erickson	Chairman of the Board BOD, PMIC and PIC	1972
Carl Elmer Tingelstad	BOD, PMIC and PIC	1978
Mary Henriette Johnson	BOD, PMIC and PIC	1973
Sandra May Kurack	BOD, PMIC and PIC	1989
Shirley Liu Hodgson	BOD, PMIC and PIC	1985
Robert Dean Sealey	BOD, PMIC and PIC	1972
Borge Osvald Saxberg	BOD, PMIC and PIC	1996

OFFICERS:

Officers are elected for a one year term at the Board of Directors' meeting held in January of each year. This corresponds with the election of officers for PMIC at its annual BOD meeting which is held immediately following the PMIC annual policyholders meeting. Article V, Section 1 of the bylaws specifies that "The newly elected Board of Directors shall meet immediately following the meeting of the stockholders at which said Board is elected." The annual meeting of the stockholders is held in April of each year in accordance with the bylaws. The Company should follow the bylaws and elect officers in the BOD meeting immediately following the annual stockholders meeting (see Instruction 3). Officers on December 31, 1998 were:

Stan William McNaughton	President and Chief Operating Officer
Richard Stanley White	Secretary
Robert William Howisey	Vice President and Treasurer
Charles Irwin Palmerton	Vice President
Ed Kenneth Erickson	Vice President

COMMITTEES:

The Board of Directors elects an Executive Committee at the same time it elects its officers. An Investment Committee was also active during the period of examination. Committee reports were routinely submitted to the BOD for review and approval where applicable.

CORPORATE RECORDS:

The initial **Articles of Incorporation** were adopted by the Board of Directors April 26, 1972. There have been no amendments since the originals were adopted. The initial Articles of Incorporation were authorized by the Board of Directors and filed with the state of Washington in accordance with the Washington Insurance Code.

The **corporate bylaws** were amended two times during the period of this examination. On October 16, 1995, Article VI, Funds and Checks, Sections 1 and 2, were amended to add the phrase, "or electronic fund transfers" to modify the words "check" or "checks" wherever they appear. A new article section 3b, regarding compensation of directors and officers was added to Article IV, Section 3 on April 15, 1977.

The Board of Directors authorized all changes to the corporate bylaws. However, none of the amendments were filed with the Insurance Commissioner as required by **WAC 284-02-080(8)** (see Instruction 1). In addition, the general interrogatory question in the annual statements for each of the respective years, "Has any change been made during the year of this statement in the charter, by-laws, articles of incorporation, or deed of settlement of the company?", was answered, "No". **RCW 48.05.250** requires an annual statement without errors (see Instruction 2).

The minutes of all Board of Directors' meetings held during the examination period (January 1, 1993 through December 31, 1998) and the subsequent two year period, 1999 and 2000, were reviewed for significant subject matter, an indication of member activity and participation. Board of Director activity was also reviewed with consideration for compliance with the Washington Insurance Code and compliance with the Company's Articles of Incorporation and Bylaws.

The Board of Directors was active throughout the examination period. Meetings were well attended and the minutes were in sufficient detail and substance to demonstrate that the Board of Directors' members were actively involved in the administration of the affairs of the Company. All meetings were documented in written form, noting items of discussion and specific actions taken.

AGREEMENTS

The Company is a participant in several agreements among affiliates and, as a member of an insurance company holding system, these have been filed pursuant to RCW 48.31B.025. As of December 31, 1998, the Company was party to the following agreements:

Cost Sharing Agreements: The affiliated companies have extensive cost sharing activities among themselves. PEMCO Mutual Insurance Company owns the real estate occupied by the affiliated companies and leases specified space to the affiliated companies per periodic amendments to the Agreement of Lease. PMIC from time to time also procures products, supplies, and services on behalf of the affiliated companies.

PEMCO Corporation, per agreement, provides data processing services, and leases automobiles and office equipment to the three insurance companies, the Public Employees Insurance Agency, and the other non-insurance companies under common management.

PMIC pays certain shared general expenses that benefit all of the affiliated companies. Reimbursement for products, supplies, and services is subject to a general "Reimbursement Agreement" dated January 1, 1990. Allocations are based on actual benefits received or by the same head count data that is used to allocate the expenses of the Supplemental Pension Fund. Affiliates are billed and reimburse PMIC on a monthly basis.

PMIC pays all expenses for PIC. PMIC is totally responsible for all non-auto line of business expense. All auto line of business expense is allocated between PMIC and PIC based upon a ratio of in-force policy counts at December 31st of the prior year. PIC reimburses PMIC for its share of expenses on a monthly basis.

Other ad hoc expense allocations occur based on specific contract or usage. A specific contract can be for a project, product, or service and is allocated based on an agreed percentage between two or more of the affiliated companies. Specific usage relates to vendor invoices that include goods or services that have been ordered by two or more of the affiliated companies, but is on one invoice. The affiliated company paying the invoice is reimbursed by the other affiliated companies on a monthly basis.

The following cost sharing agreements were in effect as of the examination date:

- Reimbursement Agreement (products, supplies and services)
- Lease Agreement (office space)
- Computer Service Agreement (software development and maintenance)
- Consulting Service Agreement (special projects)
- Master Equipment Lease Agreement (auto, computers, furniture and other equipment)

Officers of each company signed the agreements, and procedures and guidelines followed by the company indicate that expenses were equitably distributed with no affiliated company gaining an undue advantage because of inappropriate expense allocation. There were no other agreements that would indicate a material contingent exposure to the Company's assets. Settlement among the affiliates was on a monthly basis.

Tax Allocation Agreement: The Company files a consolidated federal income tax return with its parent, PEMCO Mutual Insurance Company. The method of allocation between the companies is subject to an agreement approved by the Board of Directors. Allocation is based upon separate return calculations with current credit for net losses. PMIC periodically pays the IRS estimated taxes for both companies and PIC reimburses PMIC for its estimated portion through the affiliated company receivable/payable account within fifteen days after month end closing. The final inter-company tax balances are settled annually during the filing quarter.

General Agency Contract: There is a general agency contract between the Company and the Public Employees Insurance Agency. This is a continuation of the October 4, 1948 General Agency Contract between the late Robert J. Handy, Public Employees Mutual Casualty Company, and Public Employees Mutual Insurance Company. The General Agency Contract was purchased from Mr. Handy by Public Employees Insurance Agency effective October 1, 1968. The five grandchildren of Robert J. Handy and the five children of Stanley O. McNaughton own the Public Employees Insurance Agency.

During 1998, a suit was filed against the Company by minority shareholders of Public Employees Insurance Agency, Inc. The Agency has been managed by persons who have simultaneously served as directors and officers of the Company. The suit claims that the

Agency has been operated so as to unfairly benefit the Company and asks for damages in an unspecified amount. See "Subsequent Events" (page 11).

Agency Agreement: An Agency Agreement between the Company, the Public Employees Insurance Agency, and the agent was written and effective September 1, 1985. The essence of this agreement outlines how premiums are collected and forwarded to the Company, the payment of commissions and other expenses, and how profits are shared.

INTERNAL SECURITY

Custodial Agreements: PEMCO Insurance Company security custodial agreements have been appropriately executed and contain the appropriate language set forth in the NAIC Financial Examiners Handbook.

Conflict of Interest and Confidentiality Policy: The affiliated companies have a combined Conflict of Interest and Confidentiality Policy which requires the annual completion of a Conflict of Interest Statement by officers, directors, and key employees. All are required to disclose to the President, Chairman, or Board of Directors of the appropriate company, relevant outside interests, memberships, associations, and affiliations. All appropriate persons have complied with this policy. Conflict of Interest and Confidentiality Policy information is periodically discussed by and noted in the PMIC and PIC Board of Directors' joint meeting minutes.

The policy and the indicated activity by the affiliated companies demonstrate that the Company takes great effort to protect the confidentiality of the Company strategy, all records, data and any other information of a private or sensitive nature. No conflicts have been disclosed that would indicate a failure to give an undivided and unselfish loyalty to the company which demands that there be no conflict between corporate duties and self-interest.

Fidelity Bond and Other Insurance: A fidelity insurance policy is purchased by PEMCO Mutual Insurance Company and covers the affiliated companies. Coverage limits to \$5,000,000 are provided for all of the affiliated companies insured. The minimum amount recommended by the NAIC is \$1,500,000. The aggregate amount of coverage appears adequate to cover the exposure risk of the Company and its affiliates.

The Company is also provided protection against certain property and liability losses as a named insured on other policies obtained by PMIC. Policies in effect at December 31, 1998 provided coverages for real and personal property, commercial general liability, umbrella/excess liability, insurance agents/brokers professional liability, financial institution fidelity bond, fiduciary liability, directors & officers liability, errors & omissions liability.

EMPLOYEES' BENEFIT PLANS

All employees of the affiliated companies are eligible to participate in certain affiliated company sponsored insurance programs and benefit plans on the first of the month following an introductory period. Programs and eligibility vary according to employee status. Each company pays its own employees' salary and associated benefits.

The Company offers the following benefits: medical insurance, a dental assistance plan, long-term disability insurance, long-term care insurance, life insurance, optional life insurance, retiree medical, dental and other benefits.

The Company offers a 401(k) Savings and Profit Sharing Plan. This is a defined contribution plan where the employer pays eligible employees for their contributions to the continued

success of the Company. One to ten percent of pay may be contributed to the plan with immediate 100% vesting. The Company contributes 200 percent matching on the first 6% of the employee contribution. Additional discretionary Company contributions may be made at the end of each year. After three years of service, the Company contributions are 30% vested and become fully vested after seven years of service. There are several options for withdrawal.

The Company also offers the usual options for time off from work including personal days, vacation, sick leave and the traditional holidays.

TERRITORY AND PLAN OF OPERATION

PEMCO Insurance Company is authorized to transact property, vehicle, general casualty, and surety business in the state of Washington.

The Company operates on a cash premium plan of insurance. The Public Employees Insurance Agency, Inc., operates as an exclusive general agent authorized to transact insurance business for the Company. On December 31, 1998, there were 190 agents licensed and appointed to transact business for the Company.

The Company has a branch office in Spokane, Washington and a satellite processing center in Lynnwood, Washington. Claim branch service offices are located in Tacoma and Yakima, Washington. The Company also has five smaller drive-in offices throughout the state that settle small property damage claims. The majority of claims are handled directly through its home office on a twenty-four hour basis.

The Company uses staff adjusters in the settlement of claims. Independent adjusters are used in areas not serviced by Company personnel.

REINSURANCE PROGRAM

The Company has five reinsurance contracts in place as of December 31, 1998, all of which name both PMIC and PIC as the ceding companies. PIC does not participate in the two facultative agreements and one of the three treaty agreements.

The assuming companies are all rated A or better by AM Best. The agreements cover all the property and casualty lines of business written by PMIC and PIC. Retention levels vary by agreement.

The treaty agreements in effect during 1998 are based upon earned premiums. The reinsurer agrees to share a portion of the premium and expense on risks that have already been bound and are in force. The reinsurer does not retain the right to refuse coverage on a policy by policy basis.

One treaty agreement provides casualty excess of loss reinsurance covering major perils liability. The policy is structured on an incurred basis. In the years prior to 1996 the agreement detailed three layers, but that was reduced to two layers for 1996 and 1997. On December 15, 1997, these two layers were changed to one layer retroactive to January 1, 1997. The premium rate was originally .35% and .17% for the two layers effective January 1, 1996. The rate for the retroactive change was .40% of earned premiums. The agreement during 1998 and 1999 was in a single layer, reinsuring 100% of losses up to \$4,500,000 in excess of \$500,000 per occurrence. The premium rate for 1998 and 1999 was 28%.

Another treaty agreement is a property catastrophe excess of loss reinsurance agreement involving fourteen participants. The major participant, consisting of Lloyd's Syndicates, is obligated for 60% of the interests and liabilities set forth under the agreement. The cover is 90% of \$200,000,000 excess \$50,000,000 each and every loss occurrence. The premium rate was 6.45% of gross net earned premium income.

Reinsurance agreements were reviewed for compliance with Washington State reinsurance statutes. The contracts have the standard insolvency clause wording required by the Washington Insurance Code to minimize the Company risk. PIC does not do business with unauthorized reinsurers.

The President and the Vice President routinely review the reinsurance program to be sure that the exposure to risk is limited by spreading of that risk through the various reinsurance contracts. Based upon our review, the Company appears to be adequately monitoring its reinsurance program and the overall reinsurance program appears to be adequate for the Company's exposure and ability to assume risk.

INFORMATION SYSTEMS AND ACCOUNTING RECORDS

PEMCO Corporation provides all of the affiliated companies with EDP services. The management of CORP is sufficiently knowledgeable of EDP issues and the various department managers work with the IS Department to provide direction and oversight. Systems development, acquisition, and maintenance controls were evaluated to gain assurance that programs and systems are designed, tested, approved, and implemented using appropriate controls. The Company has detailed written documentation for its major operations and financially significant applications, proper supervision and review for each project to ensure satisfactory completion, and an Internal Audit Department that includes an EDP specialist.

Operations, processing, and documentation controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; back up and recovery facilities employed; and the controls exercised to maintain data security. Adequate procedures and controls are in place for its mainframe operations and PC's.

The Company has also prepared a detailed written contingency plan to ensure its ability to service the needs of its policyholders in the event of any unforeseen circumstances.

ACTUARIAL

The casualty actuarial staff employed by the Office of Insurance Commissioner, state of Washington, performed the actuarial review of the Company's reserves. The Company provided loss and loss adjustment expense development data by accident year and sub-line. The actuarial staff obtained additional information by interviewing several Company employees. They also reviewed an actuarial report prepared by the Company's consulting actuarial firm.

The reserves carried by the Company for the unpaid losses and loss adjustment expenses were \$33,173,356 and \$7,660,541, respectively, as of December 31, 1998.

The actuarial staff's estimates indicate that the reserves for both losses and loss adjustment expenses, on a net basis, are within a reasonable range. Therefore, these reserves are accepted as they appear in the Company's 1998 annual statement.

SUBSEQUENT EVENTS

Ownership and Control: There have been no changes in ownership and control of the Company. However, during the subsequent years to the examination date, there were changes within the holding company system.

PEMCO Corporation separated into two separate companies effective July 1, 2000. CORP remains the owner of PLIC and continues to focus on computing services. The new company, PEMCO Technology Services, will concentrate on electronic transaction processing (formerly called PowerLink).

PEMCO Insurance Agency: On May 19, 2000, the Company acquired the outstanding shares of the Public Employees Insurance Agency, Incorporated (the "Agency") for approximately \$6,496,000. The Agency was previously owned by individuals and provided insurance agency services to the Company for commissions and reimbursement of substantially all operating costs. This acquisition resolves previous litigation matters between the Company and the Agency's minority shareholders. A premium payment was made in addition to the purchase price and has been recorded as a surplus adjustment rather than a charge to operations under GAAP accounting, and reflected as a surplus contingency reserve at December 31, 1999, as permitted by the Office of Insurance Commissioner.

FINANCIAL STATEMENTS

The following statements reflect the financial condition of the Company as of December 31, 1998, as determined by this examination:

Balance Sheet
As of December 31, 1998

Comparative Balance Sheet
As of December 31, 1997 and 1998

Statement of Income
Year Ended December 31, 1998

Comparative Statement of Income
For the Years Ended December 31, 1997 and 1998

Capital and Surplus Account
As of December 31, 1998

Comparative Capital and Surplus Account
Years Ended December 31, 1997 through 1998

PEMCO INSURANCE COMPANY

BALANCE SHEET AS OF DECEMBER 31, 1998

	BALANCE PER COMPANY	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION	Notes
<u>ASSETS</u>				
Bonds	\$102,615,248		\$102,615,248	1
Common stocks	14,111,924		14,111,924	2
Cash and short-term investments	3,628,982		3,628,982	3
Agents' balances or uncollected premiums:				
Premiums in course of collection less ceded reinsurance	3,466,520		3,466,520	4
Premiums booked but deferred and not yet due	20,493,120		20,493,120	4
Interest, dividends and real estate income due and accrued	1,468,609		1,468,609	
Receivable from parent, subsidiaries and affiliates	104,090		104,090	5
Total Assets	<u>\$145,888,491</u>		<u>\$145,888,491</u>	
<u>LIABILITIES</u>				
Losses	\$33,173,356		\$33,173,356	6
Loss adjustment expenses	7,660,541		7,660,541	6
Contingent commissions and other charges	211,830		211,830	
Other expenses (excluding taxes, licenses & fees)	1,503,139		1,503,139	
Taxes, licenses & fees (excl. fed. inc. tax)	164,547		164,547	
Unearned premiums	34,569,762		34,569,762	7
Amounts withheld by company for others	1,445		1,445	
Drafts outstanding	3,119,179		3,119,179	
Payable to parent, subsidiaries and affiliates	4,957,011		4,957,011	5
Aggregate write-ins for liabilities	150,496		150,496	
Total liabilities	<u>85,511,306</u>		<u>85,511,306</u>	
<u>SURPLUS AND OTHER FUNDS</u>				
Common capital stock	1,000,000		1,000,000	
Gross paid in and contributed surplus	1,000,000		1,000,000	
Unassigned funds (surplus)	58,377,185		58,377,185	
Surplus as regards policyholders	60,377,185		60,377,185	
Total liabilities, surplus and other funds	<u>\$145,888,491</u>		<u>\$145,888,491</u>	

PEMCO INSURANCE COMPANY

COMPARATIVE BALANCE SHEET

AS OF DECEMBER 31,

	<u>1998</u>	<u>1997</u>
<u>ASSETS</u>		
Bonds	\$102,615,248	\$96,349,565
Common stocks	14,111,924	12,945,889
Cash and short-term investments	3,628,982	2,072,438
Agents' balances or uncollected premiums:		
Premiums in course of collection less ceded reinsurance	3,466,520	2,510,664
Premiums booked but deferred and not yet due	20,493,120	17,756,154
Interest, dividends and real estate income due and accrued	1,468,609	1,437,708
Receivable from parent, subsidiaries and affiliates	104,090	38,597
	<u>\$145,888,491</u>	<u>\$133,111,016</u>
<u>LIABILITIES</u>		
Losses	\$33,173,356	\$32,845,564
Loss adjustment expenses	7,660,541	6,197,913
Contingent commissions and other charges	211,830	202,701
Other expenses (excluding taxes, licenses & fees)	1,503,139	1,322,550
Taxes, licenses & fees (excl. fed. inc. tax)	164,547	191,072
Unearned premiums	34,569,762	32,624,055
Amounts withheld by company for others	1,445	1,538
Drafts outstanding	3,119,179	3,122,478
Payable to parent, subsidiaries and affiliates	4,957,011	2,704,066
Aggregate write-ins for liabilities	150,496	148,345
Total liabilities	<u>85,511,306</u>	<u>79,360,282</u>
<u>SURPLUS AND OTHER FUNDS</u>		
Common capital stock	1,000,000	1,000,000
Gross paid in and contributed surplus	1,000,000	1,000,000
Unassigned funds (surplus)	58,377,185	51,750,731
Surplus as regards policyholders	60,377,185	53,750,731
Total liabilities, surplus and other funds	<u>\$145,888,491</u>	<u>\$133,111,013</u>

PEMCO INSURANCE COMPANY
STATEMENT OF INCOME
AS OF DECEMBER 31, 1998

	BALANCE PER COMPANY	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION	Notes
<u>UNDERWRITING INCOME</u>				
Premiums earned	\$66,912,078		\$66,912,078	
DEDUCTIONS:				
Losses incurred	40,846,711		40,846,711	
Loss expenses incurred	10,328,585		10,328,585	
Other underwriting expenses incurred	16,298,966		16,298,966	
Total underwriting deductions	67,474,262		67,474,262	
Net underwriting gain or (loss)	(562,184)		(562,184)	
<u>INVESTMENT INCOME</u>				
Net Investment Income earned	6,776,736		6,776,736	
Net realized capital gains or (losses)	1,746,568		1,746,568	
Net investment income gain or (loss)	8,523,304		8,523,304	
<u>OTHER INCOME</u>				
Miscellaneous income				
Total other income				
Net income before federal and foreign income taxes	7,961,121		7,961,121	
Federal and foreign income taxes incurred	2,931,781		2,931,781	
Net income	\$5,029,340		\$5,029,340	

PEMCO INSURANCE COMPANY
COMPARATIVE STATEMENT OF INCOME
FOR THE YEARS ENDED DECEMBER 31,

	<u>1998</u>	<u>1997</u>
<u>UNDERWRITING INCOME</u>		
Premiums earned	\$66,912,078	\$60,153,785
DEDUCTIONS:		
Losses incurred	40,846,711	42,563,809
Loss expenses incurred	10,328,585	7,865,650
Other underwriting expenses incurred	16,298,966	16,878,531
Total underwriting deductions	67,474,262	67,307,990
Net underwriting gain or (loss)	(562,184)	(7,154,205)
<u>INVESTMENT INCOME</u>		
Net Investment Income earned	6,776,736	6,555,507
Net realized capital gains or (losses)	1,746,568	1,235,696
Net investment income gain or (loss)	8,523,304	7,791,203
<u>OTHER INCOME</u>		
Miscellaneous income		(21)
Total other income		(21)
Net income before federal and foreign income taxes	7,961,121	636,978
Federal and foreign income taxes incurred	2,931,781	298,899
Net income	\$5,029,340	\$338,079

PEMCO INSURANCE COMPANY

CAPITAL AND SURPLUS ACCOUNT

AS OF DECEMBER 31, 1998

	BALANCE PER COMPANY	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION	Notes
Surplus as regards policyholders, December 31, previous year	<u>\$53,750,731</u>		<u>\$53,750,731</u>	
<u>GAINS AND (LOSSES) IN SURPLUS</u>				
Net income	5,029,340		5,029,340	
Net unrealized capital gains or (losses)	1,588,330		1,588,330	
Change in non-admitted assets				
Extraordinary amounts of taxes for prior years				
Miscellaneous surplus adjustment	<u>8,784</u>		<u>8,784</u>	
Changes in surplus	<u>6,626,454</u>		<u>6,626,454</u>	
Surplus as regards policyholders, December 31, current year	<u><u>\$60,377,185</u></u>		<u><u>\$60,377,185</u></u>	

COMPARATIVE CAPITAL AND SURPLUS ACCOUNT

AS OF DECEMBER 31,

	<u>1998</u>	<u>1997</u>	<u>1996</u>	<u>1995</u>	<u>1994</u>
Surplus as regards policyholders, December 31, previous year	<u>\$53,750,731</u>	<u>\$50,277,568</u>	<u>\$49,341,367</u>	<u>\$43,946,280</u>	<u>\$41,234,023</u>
<u>GAINS AND (LOSSES) IN SURPLUS</u>					
Net income	5,029,340	338,079	982,025	2,612,586	3,220,287
Net unrealized capital gains or (losses)	1,588,330	2,227,523	565,027	2,770,005	(177,283)
Change in non-admitted assets		877,261	(877,261)		
Extraordinary amounts of taxes for prior years			230,398	(12,810)	(455,346)
Miscellaneous surplus adjustment	<u>8,784</u>	<u>30,300</u>	<u>36,012</u>	<u>25,306</u>	<u>124,599</u>
Changes in surplus	<u>6,626,454</u>	<u>3,473,163</u>	<u>936,201</u>	<u>5,395,087</u>	<u>2,712,257</u>
Surplus as regards policyholders, December 31, current year	<u><u>\$60,377,185</u></u>	<u><u>\$53,750,731</u></u>	<u><u>\$50,277,568</u></u>	<u><u>\$49,341,367</u></u>	<u><u>\$43,946,280</u></u>

NOTES AND COMMENTS TO FINANCIAL STATEMENTS

1. **BONDS** represent 70.338% of Total Assets and 169.957% of Total Surplus. Bonds are stated at amortized cost and all are investment grade bonds with a SVO rating of 1 or 2. Amortized cost is computed using the effective interest method. Investment grade loan-backed bonds and structured securities are reported at amortized cost using the interest method including anticipated prepayments at the date of purchase.

The Company filed all bonds with the Securities Valuation Office (SVO) when not previously listed.

2. **COMMON STOCKS** represent 9.673% of Total Assets and 23.373% of Total Surplus. Common stocks are reported at market value. The Company's investment in Evergreen Bank (1.5%) is reported at market value.
3. **CASH AND SHORT TERM INVESTMENTS** are 2.488% of Total Assets and 6.011 % of Surplus. The balance consists of \$193,982 in cash and \$3,435,000 in two money market mutual funds and two repurchase agreements all purchased during December 1998. All are SVO class "1" issues. These were all valued at cost in accordance with the NAIC Valuations of Securities manual and the applicable section of the Washington Insurance Code.
4. **AGENTS BALANCES OR UNCOLLECTED PREMIUMS** are 16.423% of Total Assets and 39.683% Surplus. The Company has a general agent agreement that became effective in 1959 with an affiliated company, Public Employees Insurance Agency (the Agency). That agreement provides for premium collection services to be provided by the Agency. The Agency pays PIC periodically based upon the installment due dates which creates a situation wherein there are never any overdue balances.

The Company changed the accounting method used to account for premiums over 90 day's receivable for 1998. This change reflects aging of the receivable based on the due date of the installment. In the past, premiums were aged based on the anniversary date of the policy. The result of this change brought the December 31, 1997 premiums over 90 days receivable to zero. The Washington State Insurance Commissioner approved the change and prior year balances were not restated.

5. **RECEIVABLE/PAYABLE FROM PARENT, SUBSIDIARIES AND AFFILIATES** are 0.071% and 3.398% of Total Assets respectively. The affiliated companies have extensive cost sharing activities among themselves. PEMCO Mutual Insurance Company owns the real estate occupied by the affiliated companies and leases specified space to the affiliated companies per periodic amendments to the Agreement of Lease. PMIC from time to time also procures products, supplies and services on behalf of the affiliated companies. Inter-company account balances are generally satisfied within fifteen days after month end closing. Refer to "Cost Sharing Agreements" in this report for more discussion.
6. **UNPAID LOSSES AND UNPAID LOSS ADJUSTMENT EXPENSES** are respectively 21.368% and 5.251% of Total Assets and 51.631% and 12.688% of Surplus.
7. **UNEARNED PREMIUMS** are 23.696% of Total Assets and 57.256% or Surplus.

ACKNOWLEDGMENT

The cooperation extended to the examiners by the officers and employees of the Company during the course of this examination is hereby acknowledged.

In addition to Larry A. Omdal, Examiner in Charge, Constantine Arustamian, CPA, John R. Jacobson, AFE, IS Specialist, Peter M. Mendoza, CFE, CIE and D. Lee Barclay, FCAS, MAAA, Senior Actuary and James Antush, Actuarial Analyst 2, all from the Office of Insurance Commissioner, State of Washington, participated in the examination and preparation of this report.

State of Washington)
) ss.
County of King)

Larry A. Omdal, being duly sworn, deposes and says that the foregoing report subscribed by him is true to the best of his knowledge and belief.

Larry A. Omdal
Examiner in Charge

Subscribed and sworn to before me on this _____ day of _____, 2002.

Notary Public in and for the
State of Washington,
residing at _____